

China: Heading for Tough Times

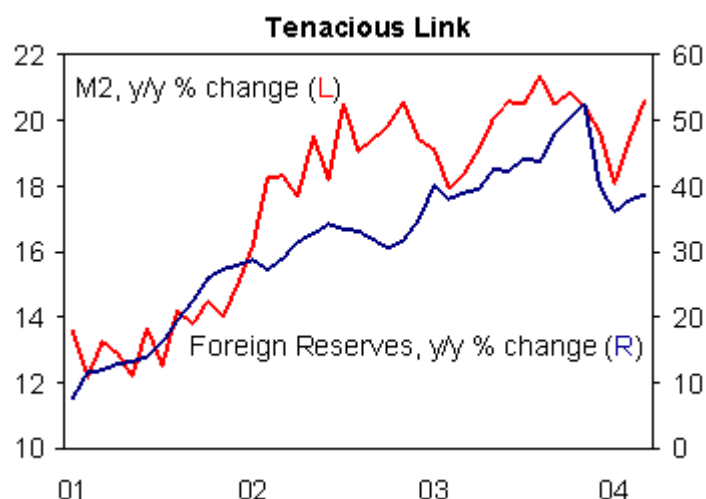


By Virendra Singh in West Chester
May 17, 2004

China's economy is in trouble. Signs of an overheated economy abound, not only in construction-related industries like cement, steel, copper and aluminum, but also in automobiles, electronics and electrical goods, and telecommunications equipment. Some of these are cyclical industries that expect to double their capacity in the next several years.

The fear in official circles is that the output of these sectors will expand so much that prices will fall and investors will have trouble servicing their loans. The banking sector, already weighed down by a large amount of nonperforming assets, may have trouble absorbing any major increase in defaults. This could precipitate a liquidity crisis that, in turn, would undermine the real economy and further complicate the ongoing financial sector reforms.

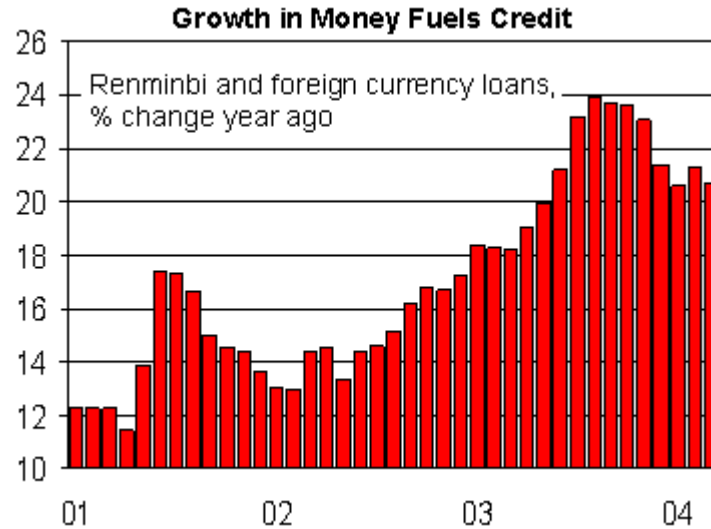
The problem in China is that the supply of money is out of control because of a fixed dollar-yuan exchange rate and the requirement that all foreign money entering the country must be converted to yuan. This has forced the government to print yuans to absorb the ever-growing inflow of foreign money, although some of this new money has been sterilized through government issued bonds. The out-of-control supply of money, along with low fixed lending rates—a deadly combination—has caused credit to grow at a 20%+ rate over the past one and half years. Banks are flush with money, lending on occasion to dodgy borrowers. Credit reporting agencies have spotty databases, and risk evaluation is still in its infancy. Cheap and plentiful money has fueled growth in construction, metals, cement, automobiles and other cyclical industries. Overcapacity appears to be endemic across the industrial economy.



Signs of overheating are appearing elsewhere as well. Commodity prices have been increasing at spectacular rates worldwide, fed largely by insatiable demand from China. Inflation is running at an official annual rate of 3%, but the Hong Kong Monetary Authority estimates that the underlying rate has been over 10% since mid-2003.

The response of the People's Bank of China (PBC) so far has been to treat the burgeoning problem with a sledgehammer. The central bank recently announced increased capital requirements for lending to the steel, cement, aluminum and property sectors. In addition, regulators have instructed banks to stop all new lending to these sectors, although the scale and details of the moratorium remain unclear. The new measures were enacted

after increases in bank reserve requirements failed to yield the desired results. An increase in reserve requirement was expected to temper the explosive growth in credit by reducing the amount of money banks can lend.



Whether the restriction on lending will take the steam out of an economy, which grew at a sizzling 9.7% in the first quarter, remains to be seen. This growth, after a 9.9% increase in the fourth quarter of last year, was powered by a staggering 43% increase in fixed asset investment in the first quarter.

The lack of confidence in the measures enacted by the PBC so far stems from the sorry state of the banks in China. Most analysts believe that banks carry upward of \$500 billion in non-performing loans (NPL) on their books; this is close to one-half of China's GDP. Banks are under enormous pressure to reduce the proportion of NPL on their books because Beijing uses this ratio as the main performance criteria. This has encouraged banks to step up issuance of new loans with little regard to risk. It is therefore likely that banks will continue lending at the current furious pace to sectors other than the ones embargoed, and simply shift the investment bubble from construction-related industries to some other sectors.

Of late, the PBC has been considering a hike in interest rates. Here too, policymakers face a dilemma. Higher interest rates at this point, it is feared, will be too great a shock. Fixed investments in the past were based on a lending rate that had remained fixed for years. Higher interest rates would mean a sudden devaluation of assets and stress servicing of existing loans. A large number of companies will go under, spreading red ink across the books of the banking system. A number of banks under these circumstances are bound to become insolvent.

At this point, even higher interest rates may not be enough to slow the growth of money supply, although they are bound to arrest credit growth. As noted above, the supply of money in China is determined by the yuan-dollar exchange rate and the inflow of foreign money. The largest chunk of this foreign inflow comes in the form of foreign direct investment and net export earnings, and FDI and exports are on track this year to best last year's high marks. Higher interest rates in China are unlikely to have more than a marginal impact on FDI, and money will continue to grow at its current furious pace. Banks will have to balance their books by moving money into less lucrative assets—compared to private loans—further stressing the banking system.

To make matters worse, China's room for fiscal tightening is very limited. Although China has come a long way from a socialist economic system, resource allocation is still largely determined by the government, either through direct investments or through tax and other incentives that skew private investments in one direction or another. Over 70% of total investment comes from the public sector, and most of that is controlled by provincial governments. Under such circumstances, there is bound to be a substantial time lag between the central government applying fiscal brakes and the economy actually responding.

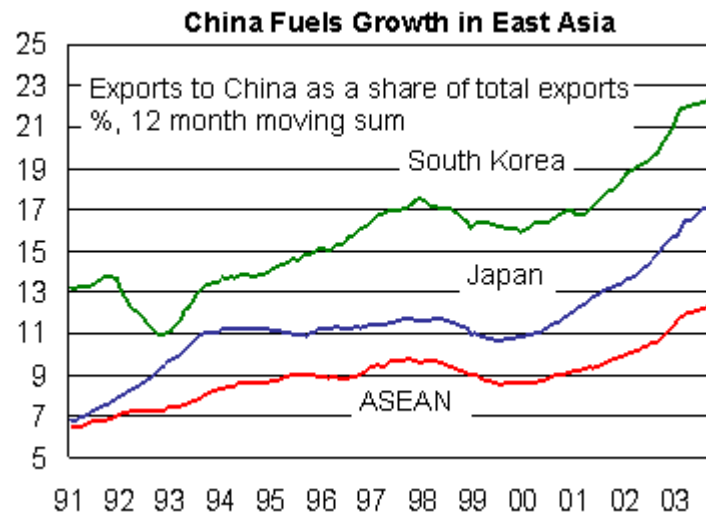
Will higher interest rates lead to a soft landing? It may be too late for that at this stage. Interest rates should have been hiked more than a year ago—Economy.com noted in the middle of last year that the Chinese economy was overheating. At this stage, the impact of higher interest rates will be unpredictably accentuated by a shallow and immature financial market. It is far more likely that the Chinese economy is headed for a hard landing with or without higher interest rates.

A more sensible way would be to arrest the growth of money by a one-time revaluation of the yuan. A 20% revaluation of the yuan will have a marginal impact on the global competitiveness of Chinese manufacturing industries. Import prices, a large portion of Chinese export prices, will also fall. Domestically, prices for imported primary and intermediate goods will also fall and dampen inflationary pressures. And, there would be no need to change interest rates.

Although the circumstances are quite the opposite, the Chinese government's stance reminds us of Argentina not too long ago, where the government tenaciously stuck to the peso-dollar peg, leading to disastrous consequences. Here, the problem is excess liquidity in an economy with a dollar peg and closed capital markets. The PBC appears intent on taking the higher interest rates and/or squeezing the economy by fiat route. Lack of a mature financial sector and other institutions will make the ride after higher interest rates wild and spectacular. However, in every cloud there is a silver lining. This may provide the government with just the opportunity to thoroughly overhaul the financial sector and shed the poorly performing state owned enterprises.

Reform of the financial sector holds the key to China's future. The main reason why the government finds itself in such a helpless position is that, at present, financial instruments in China have a limited impact on the real economy. There are no levers to pull and no steering wheel to guide the economy. Overinvestment and subsequent Schumpeterian "creative destruction" are an integral part of a vibrant market economy. Interest rates are used by monetary authorities to ease the passage from one phase of the business cycle to the next. But, for interest rates to work effectively, a deep and well regulated financial market is necessary. As China develops, it will face more business cycles. The upcoming downturn presents itself as an opportunity to thoroughly overhaul the financial sector.

Any slowdown in the Chinese economy will be felt worldwide. Most vulnerable are commodity producers, especially those exporting primary and finished metals and coal. In 2003, China's sizzling economy consumed 7% of oil, 27% of steel, 31% of coal and 40% of cement produced in the world, even though it accounted for only 4% of world GDP. Producers of capital goods should also be concerned. During the last five years, China accounted for almost 25% of the growth in global capital spending.



A slowdown in China will bring cheer to those worried by the recent unrelenting rise in commodity prices. There is little doubt that phenomenal growth in the Chinese economy has played a large role in pushing global commodity prices up. While this has been good news for commodity producers, it has caused concern that commodity prices are rising too fast for the current stage of U.S. recovery, and inflationary pressures will appear sooner than anticipated. Indeed, after the PBC announced a moratorium on new lending to construction-related sectors, there was a discernible softening of metal prices. Going forward, a slowdown in China will ease commodity prices worldwide.

Countries that are likely to bear the brunt of a Chinese downturn are China's East Asian neighbors. Indeed, a slowdown in China is the biggest threat to the incipient Japanese recovery. Two-way trade between China and ASEAN, Taiwan, South Korea and Japan has been growing at an unprecedented pace. At present, China is poised to overtake the U.S. as the largest trading partner of South Korea and Japan. A slowdown in China will ripple through East Asia and will likely impact rest of the world too.

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